DOW THEORY LETTERS INC.

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THE MARKET: This Letter is being written in two distinct sections. The first part contains the regular discussion of the shorter and intermediate term market situation. The second part includes a lengthy appraisal of the over-all picture and is much more concerned with long-term investment strategy. In reading this week's Letter it should be remembered that the day-to-day and week-to-week discussions are the most difficult, the most subject to spot news and near-term technical considerations.

Referring to chart 1, we see that the Industrial Average dropped a total of 84 points from its February 9 peak while Rails fell 28 points from their own February 9 high. These declines served to erase 53% (Industrials) and 33% (Rails) of the entire gains recorded on the last primary advance (i.e. the advance from the June, 1965 low to the February, 1966 high). The elapsed time for the February-March decline was approximately five weeks, and the lows (whether temporary or permanent) were touched on March 16 at 911.08 for Industrials and 243.60 for Rails. In both duration and extent the drop qualifies as part or all of a full secondary reaction.

From the standpoint of orthodox Dow Theory, the exact character and quality of the latest advance (from the March lows) is not important. What is important is the question of whether the advance is to be a full retracement of the February-March decline. If the current advance lasts approximately a week and a half or longer, and if it succeeds in retracing approximately one-third or more of the ground lost during the February-March decline, then the Dow Theory will come into particular prominence. The reason is that following a full reaction, if the subsequent upward correction succeeds in taking the two Averages to new bull market highs (in this case above 995.15 and 271.72), the primary bull trend will be reconfirmed. On the other hand, if the upward full correction fails to take both Averages over the old highs, and the Averages then turn down, the situation will become critical. For if both Averages then penetrate their preceding reaction lows on heavy volume, a bear signal will have been rendered. In that case Dow's Theory will have given its most important warning, a reversal of the primary trend from bull to bear market.

In other words, the important factor now is whether we get a sufficient upward movement and whether this upward movement consumes enough time. I would say that the

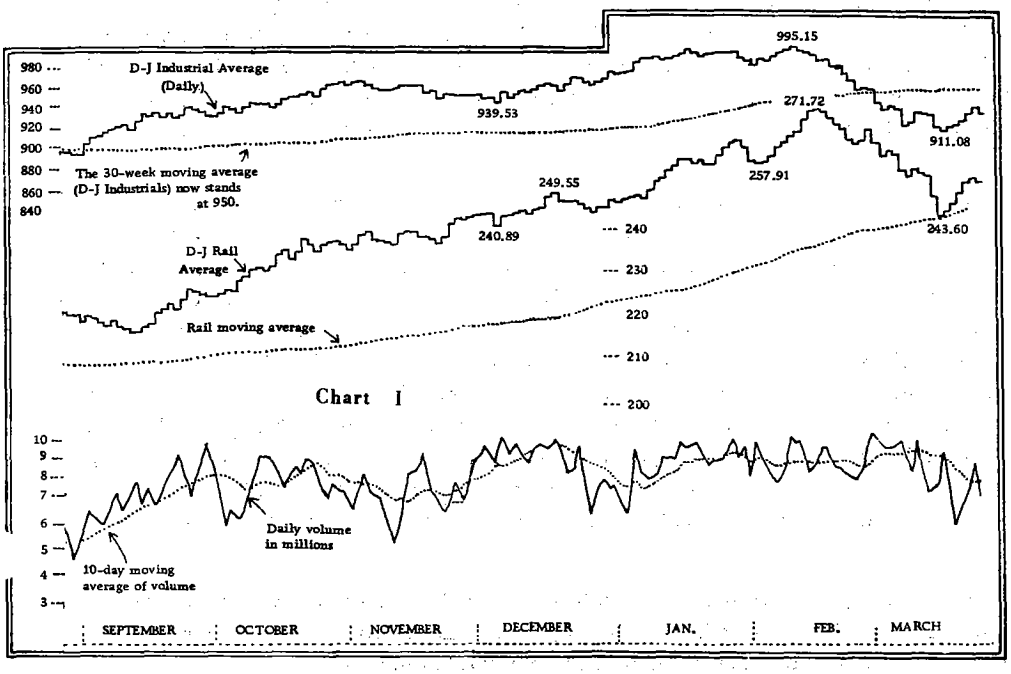
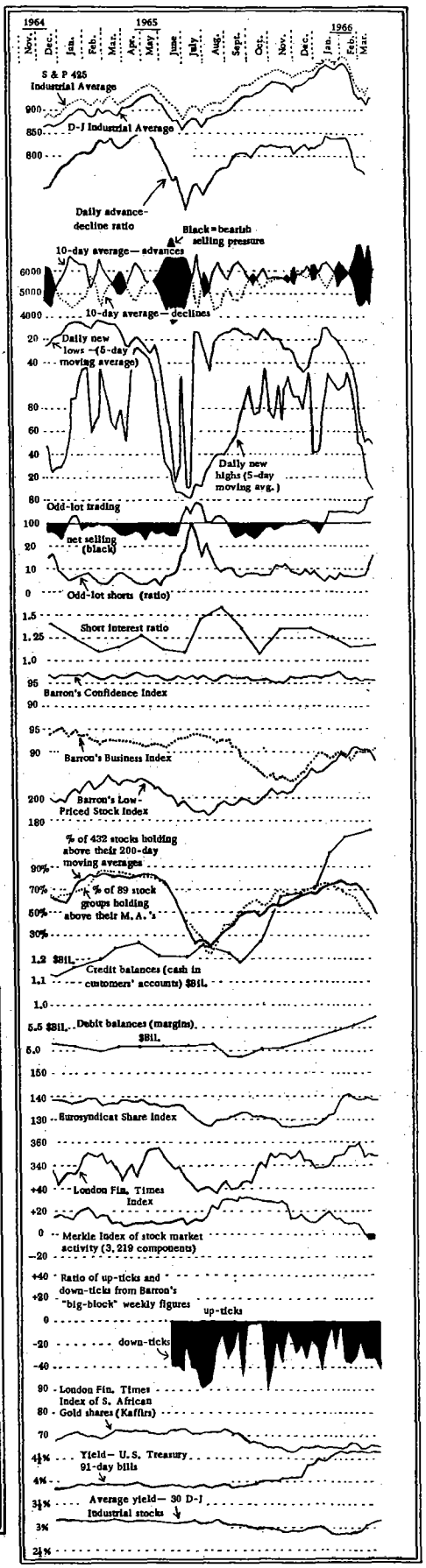


Chart I


1964
1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows — (5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

minimum expectation for a "full upward movement" from here for Dow Theory purposes would be an advance that carries Industrials back to around the 940 area or better and Rails back to approximately the 255 area or better. Such a rally should take at least 10 trading days or more. Following such a potential retracement, if the Averages then turn and break the preceding lows on heavy volume I would say that a bear signal had been given. On the other hand, if the rally proves to be sub-normal and the lows are soon broken again I would consider it merely an extension of the secondary downtrend. Obviously, if the rally gathers upside momentum and the two indicators rally above the February highs, we would conclude that the primary trend continues bullish.

From the near-term standpoint, I note that many analysts feel that the March 16 lows were not accompanied by climactic selling characteristics. As a rule, most violent declines terminate with a good deal more "public fear" than was evidenced at the lows, and the absence of such selling climax indications has prompted some distrust of the rally by technicians. But the market can do anything, and no one can say with certainty at this time that a full correction or even new bull market highs are not in the cards. One of the reasons why a selling climax was not seen at the March 16 lows is that at no time during the entire decline did real fear ever grip the market. On the contrary, my impression was that the decline was accepted in general as a golden opportunity to load up on stocks at bargain prices.

Odd-lot buying was in evidence during the whole decline, and interest in the glamour stocks continued unabated, even while prices fell. These same characteristics have accompanied the rebound, and interest has centered not on the big Dow stocks but on the Airlines, Television stocks, low-priced stocks and other specialties. Odd-lot transactions have shown a heavy bias on the buying side during the climb back. It all boils down to this: the public was clearly unmoved by the February-March decline, and they are just as clearly very enthusiastic about the rally from the March lows.

My feeling is that from here on the temptation may be to try to read too much into all the various short-term indicators and signals. I would rather let the simple Dow Theory precepts show themselves in the weeks or months ahead. If it is really a bear market, we will know it in good time, and (if or when the March lows are broken) we will probably know it with frightening clarity. On the other hand, if the highs are approached and bettered the question will arise, "Is it a whole new ball game?" Here I would be very careful. My reasons for being careful, despite the possibility of a reconfirmation of the bull trend, are outlined in the second part of this Letter.

The Composite Chart shows the effects of the drop to the March 16 lows and the most recent rally. The "over-sold" condition of the market has been relieved as seen by the rise of the 10-day average of advances above declines. New highs and lows have switched over to the 1966 basis, and it will be a few weeks before these fully adjust. Odd-lots were discussed above and cannot be considered bullish. Both debits (margin loans) and credits (free cash in customer's accounts) were up for February, and on the face of it this should be bullish for the market. The percentage of stocks holding above their moving averages dropped last week below 50% for the first time. The Merkle Index is still bearish at minus 8. Conclusion: Only debits and credits are outstandingly bullish at this time. The majority of the other indicators present negative or bearish profiles.

QUESTION FROM SUBSCRIBER: Russell, I'm an open-minded fellow. You say that I should be getting out of the market now. But why? Why was this decline any different from the drop in 1957, 1959 or 1962? Each time after those declines the market reversed itself and rallied to new highs. What are your arguments to suggest that the current decline is any different from those previous declines? In other words, why should I take this particular drop seriously?

ANSWER: The only tools of the investment business are capital and knowledge. In a bull market, knowledge will aid you in building your capital. In a bear market knowledge can help you keep your capital. Robert Rhea used to say that the test of the investor was the full round-trip. It was how much cash a man had after the completed trip through a bull market and a full bear market that counted. Many men make a killing during a bull market only to lose it ingloriously in the subsequent bear market. It's a case of zero to 100 and back to zero; the net result is zero and a lot of excitement. This is the type of round trip I would like my subscribers to avoid.

Therefore, I am going to present my case for being out (or if you are not out, for getting out) in the current area. This is where each subscriber will have to exercise his own intelligence and judgment. I may be wrong. Plenty of keen minds do disagree with me. Leading industrialists may disagree with me. Top Government economists will disagree with me. A very large majority of today's 22 million investors will disagree with me. But only a tiny fraction of all the investors ever get out of a bull market near the top. And only a minute portion of the nation's investors ever get into the next bull market anywhere near the bottom. In 1949 volume was running at a rate of only ½ to 1 million shares per day. This represented the volume produced by investors who were buying at the very beginning of the great bull market. Today volume is running on an average of 8 to 9 million shares per day. Interest is usually intense near the top. Since September, 1965, a huge volume of shares has turned over. Over one-billion shares were traded in the period from September, 1965 to February, 1966. All these shares were traded above the 920-930 level. Suppose the Dow does not go back substantially above 930? This will mean that one billion shares have been "locked in" at high prices. That is something to think about. Even now it represents a massive "supply" which may want to get out if and when the chance arises again.

At any rate, here are my reasons for believing that the great bull market which began in 1949 could be in a gradual process of cracking up. Study them and make up your own mind. Nobody is going to make up your mind for you. This is a lone business, and you are most alone when you have to make a decision which may go against the prevailing opinion.

(1) The time element of the whole bull movement has been extraordinarily long. The rise in the Industrial and Rail Averages has lasted (so far) 16 years. This is twice as long as the 1921-29 bull market, the previous longest bull market in history. But why couldn't this bull market last another 2, 3 or 5 years? The answer is that it could, but this does not eliminate the unfavorable time consideration. The longer this bull market lasts, the nearer it is to the end. Unless "the tree can grow to the sky," the fantastic age of the bull market must be considered an adverse factor.

(2) The extent of the bull movement has been a record breaker. From the 161.60 level of June, 1949, the Industrial Average has risen 517% to the February, 1966 peak of 995.15. This compares with the 1921 to 1929 rise of 495%. The 1921-29 movement was considered the greatest speculative stock market boom in history, but we have surpassed it during the last 16 years. The 1921-29 rise started in the depression of 1920 and ended by discounting the hopes and dreams of "The Jazz Age" and the "New Era." The rise which started in 1949 began with the recession of that year and continued through "The Fair Deal," "The New Frontier" and into that period which has been immodestly termed "The Great Society." By any calculation it has been a long climb and a swing from the depressed psychology of 1949 to the swinging, go-go years of the mid-1960's.

(3) I consider that the third or speculative phase of the bull market lasted from 1958 (when the yield on the Dow first dropped into the 3% zone) to the present. During all of this period optimism (with brief respites such as 1960 and 1962) reigned. During most of this period stocks, on an historical basis, were in an overvalued area. During most of this period, speculation was rampant, hundreds of new issues were introduced, and almost every individual stock on the N.Y.S.E. had its own speculative fling. Eight years is a very long time for speculative fever to hold sway. It is, in fact, an all-time record.

(4) Since 1959 the Government has administered huge doses of inflation to the nation. The money supply has sky-rocketed, debt has become a way of life, huge excesses of every variety have been built into the economy. And more lately the thesis of "inflation in our time" has become almost universally accepted. Currently, borrowing, hiring, capital investment and inventorying are all occurring at the same time. The economy is still running at white heat during one of the longest periods of economic boom in the nation's history. Reflecting the activity, money markets are short of supply and interest rates are generally the highest in a generation. All of these are characteristics of major top areas.

(5) As discussed in detail in Letter 314, both the utility and bond averages are still in long downtrends. Historically, such action has often preceded major tops in the stock market. While no infallible prediction can be deduced from utility and bond trends, the fact remains that these trends are definitely bearish for the market.

(6) More recently the Industrial and Rail Averages turned down. On March 1 the Industrial Average broke through both the December, 1965 low of 939.55 and the moving average which now stands at 951. At the March low of 911.08, Industrials had succeeded in wiping out 54% of the entire gains of the last primary bull swing (the last bull swing was the movement from the June, 1965 low of 840.59 to the February, 1966 high of 995.15). The current relationship of the Industrial Average to its own moving average is not favorable. The fact that the February-March drop broke the halfway level of the preceding primary bull advance is also not favorable.

(7) Another consideration which was analyzed in the last Letter is that the February-March drop was not set off by any specific news event. The true reason for the drop is still not clear. Many argue that tight money was responsible for the decline, but money has been tight for many months now, and even on the money front nothing occurred specifically in February to "trigger" the market decline. Most bear markets start as technical phenomena. In other words most bear markets are set off by internal factors, not external events. Bear markets begin when the technical structure of the market is greatly weakened, and bear movements, particularly in the early stages, usually represent situations where the market falls "of its own weight." The February-March decline appeared to fit that description.

(8) As outlined in Letter 308, bank credit studies from the authoritative Bolton Tremblay Bank Credit Analyst are, and have been, at the warning stage. The Bolton studies show 10 "bearish" signals. These occurred in 1919, 1923, 1929, 1937, 1940, 1946, 1951, 1955, 1959 and the latest in June, 1965. The average lead time (prior to a stock market top) for these signals was about six months. The longest lead times occurred in 1951 and 1955 when the lead times were 8 months. If February represented the market top in 1966, then the lead time would again have been 8 months. At any rate, Bolton's bank studies must be considered a definite bearish factor for this market.

(9) I feel that the principle of contrary opinion may now be used in regard to both the "booming economy" and the "inflation" theses. It is generally held that the Vietnam war constitutes a guarantee that the economy will continue to boom and that inflation will continue to exert its effect. But contrarily, I believe that with the advent of tight money, new taxes, higher social security rates and the tremendous current consumer and corporate indebtedness, there is a very real chance of an economic turndown in late 1966—and this despite the war. This nation has been playing the "Gross National Product" game for so long that it does not realize that it is possible to have a war-spurred booming G.N.P. and at the same time have lower corporate earnings, lower take-home pay for individuals and a contraction in the huge consumer sector of the economy. But that is what could occur.

(10) The existence of an ample supply of credit is an utter necessity for a boom, and as already explained the credit picture is in for potential trouble all across the board. The second necessity for a boom is confidence. This too, in my opinion, could

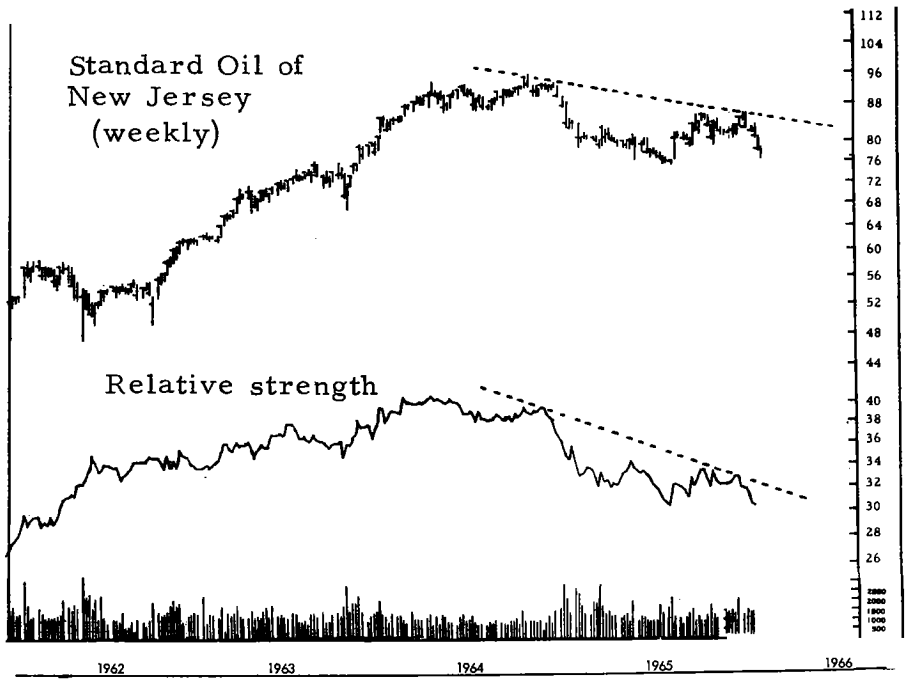
be in for drastic revision in the months ahead. Before I go into this it should be remembered that any drastic and extended decline in the stock market is bound to hurt confidence, and conversely, any breakdown in confidence will hurt the stock market. Here is why I feel that confidence may be impaired during 1966.

The American people have been accepting a great many half-truths—and for far too long. In a number of instances, the public has been accepting downright fallacies. For instance, the public now believes that they have an absolute God-given and Government—guaranteed "right" to prosperity. Tomes are still being written to extol Keynesian economics. But Keynesian economics is running into trouble, and the temperature of the money market, interest rates, is attesting to that. The public has now accepted silverless coins on the basis of pure confidence, and it has accepted irredeemable paper dollars on the same basis. The public believes that our "all powerful" Government will not let anything unpleasant occur. We have been informed that everything is "insured" by the Government or by Government agencies, but nobody has stopped to wonder what that insurance is really worth. We are constantly told not to worry because Washington has everything under control. We are led to believe that we have a President who is fully in charge, a President who is a master of getting what he wants out of Congress. All of these premises are either in the process or will be in the process of being severely tested.

All history indicates that mass psychology is subject to extended swings from pessimism to great confidence and back to pessimism again. In the face of many realities (Vietnam, monetary situation, breakdown in international cooperation, rising taxes and money rates, etc.) I believe that we are at a confidence peak, and that the burden of reality is due to slowly cut the ground from under today's unbelievable confidence on the part of the American people.

As you review the preceding 10 catagories you will note that almost all of them are long-term considerations. They fit together to make up what this writer considers the long-term outlook. From the standpoint of the big picture, it is not too important whether the Dow goes half or two-thirds of the way back to the old highs or even if the Dow touches 1000. The big picture continues to suggest to me that this is the time for the investor to move to the sidelines and await developments. I feel that today's stock prices could look very, very high a year or two years from now.

STOCKS: The Industrial Average is now below its moving average or average closing of the past 30 weeks. This is meaningful to me. It means that despite heavy odd-lot or public buying, despite frantic and continuing speculation, investors are now willing to pay less for the thirty leading Dow stocks than they have on average during the last 30 weeks. To put it in perspective, big money would seem to be growing pessimistic about the future of "blue-chip" stocks while the public is still in there attempting to make a killing in speculative issues. But make no mistake about it, the big investment money establishes the overall trend of the market. Many analysts are shouting that "you cannot buy the Averages," but they conveniently overlook the fact that a persistent trend in the leading Averages ultimately sets the trend for the great majority of stocks. When you buy even selected issues against the trend of the Averages, you are bucking the odds, and this is always a dangerous game on Wall Street.



Last week I showed a chart of General Motors, and that chart was not promising. As the Wall Street Journal put it on March 21, "Piling one good year on top of another in unprecedented fashion, car manufacturers have been the backbone of the bull market." How optimistic can we be when the leading car manufacturer shows a persistent declining trend in market performance (i.e. relative strength)?

This week I have included a long-term weekly chart of the leading oil equity, Stand Oil of New Jersey. Here the story is the same. Jersey's performance since early 1965 shows a pattern of persistent liquidation. This is another bearish omen for the market. In fact, I believe that short sales on Jersey could work out well over the next year or so, and those who wish to speculate on a further extension of the downtrend in Jersey might put out shorts with near-by stop-losses at 78.

Chart of Jersey courtesy of Traders Research, 1431 Pearl St., Alton, Ill. 62003